United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

76-4277

Signed

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

SCHUSTER'S EXPRESS, INC.,

Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

REPLY BRIEF FOR THE APPELLANT

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1. The taxpayer contends (Br. 7-8) that the Commissioner's claim that, under the reserve method of accounting, any variations between the taxpayer's estimates and its actual disbursements would ultimately be reconciled, is without support in the record and contrary to a factual finding of the Tax Court. This attempt to rely on the factual findings of the Tax Court (e.g. R. 109-110) to support the conclusion that the change in question in this case was not a change in method of accounting ignores the critical error made by the Tax Court, viz, its failure to realize that the deduction of <u>any</u> addition to a reserve for insurance expenses and damage claims was unauthorized, and hence not allowable for income tax purposes. As we point out in our brief (pp. 17-18),

the regulations governing an addition to a reserve for bad debts--the only type of addition to a reserve which may be deducted for income tax purposes, Section 166(c) of the Internal Revenue Code of 1954 (26 U.S.C.)--specifically require that the amount added to the reserve in the current year must be adjusted to correct for any prior additions which have been shown by experience to have been excessive or inadequate. Treasury Regulations on Income Tax (1954 Code), § 1.166-4(b)(2) (26 C.F.R.) It is only logical to assume that if Congress had decided to authorize the deduction of reasonable additions to reserves for other expense items, such as the insurance expenses and damage claims at issue here, the Treasury Department would have acted to prevent tax avoidance by promulgating regulations similar to those applicable to a reserve for bad debts. Thus, an addition to such a reserve is, or should be, self correcting, and the taxpayer's annual additions to such a reserve should reflect the best available estimates of the additional funds which will be needed to pay the actual expenditures for which the reserve has been created.

As we point out in our brief (pp. 15-16), the central feature of the reserve method of accounting for a particular item of expense is the attempt to match current earnings against current expenses by estimating the amount of any forseeable expenses for the item which are economically attributable to operations of the current period, and charging such estimates against current income even though the related disbursements are not made until a later period. The balance in the reserve thus created represents at any time the accumulated estimates of costs for the

item in question, less the amounts of any disbursements already made and charged to the reserve. See, Finney and Miller, Principles of Accounting: Intermediate, (6th ed., 1965), pp. 381-382. It follows that the balance in the reserve at any time is the amount of the previously deducted expenses which have not been matched by actual expenditures. Thus, because of the nature of the reserve itself, the entire $73,020 balance in the reserve account on June 30, 1967, had already been deducted from income but not yet matched by actual disbursements when the taxpayer was required by the Commissioner to change to the actual expenditures method. Under the taxpayer's new method of accounting, however, all actual expenditures, beginning on July 1, 1967, will be charged against income, and the previously deducted balance in the taxpayer's reserve will never be used to offset future expenses in any amount. Unless the Commissioner is allowed to adjust the taxpayer's 1968 taxable income under Section 481, a duplication of deductions in the amount of the $73,020 balance in the reserve will occur, solely because of the differing and inconsistent principles of accounting being used in the taxable years before and after the change. This is precisely the sort of inconsistency that Section 481 was intended to correct, and the proper amount of the adjustment is $73,020, as is evident from a comparison of the accounting principles on which the reserve method of accounting is based with those underlying the actual expenditures method.

2. The taxpayer claims (Br. 12) that it has been deprived of its statutory right to take advantage of the limits provided in Section 481(b)(1) and (2) of the Code because of the Commissioner's failure to notify it prior to trial of his intent to make a change of accounting method to which Section 481 would apply. In the first place, although the taxpayer argued at trial that the Commissioner was barred from relying on Section 481 because of his failure to raise the issue in his pleadings (R. 102-104), the Tax Court found that the taxpayer had in fact been given adequate warning of the Commissioner's intention to rely on Section 481, and, accordingly, held that the Commissioner was entitled to invoke that section (R. 104). Nowhere in the argument of counsel which led up to this ruling does it appear that the taxpayer was urging that it would be prejudiced because the Commissioner's delay in invoking Section 481 would bar it from applying the allocation provisions of Section 481(b)(1) and (2). Thus the Tax Court never had an opportunity to pass on the claim of prejudice which the taxpayer now, for the first time, raises in this Court. Moreover, it does not appear that the taxpayer will in fact suffer any prejudice if this case is remanded for a computation of the correct amount of the deficiency resulting from the inclusion of the $73,020 reserve balance in the taxpayer's gross income for the fiscal year ended June 30, 1968, as we requested in our opening brief (p. 20). If the taxpayer claims that either of the allocation provisions will benefit it, it will be at liberty

to introduce additional evidence in a proceeding under Rule 155 of the Tax Court Rules of Practice and Procedure with respect to the application of that provision. See, Treasury Regulations on Income Tax (1954 Code) § 1.481-2(d), Example (4), for a comprehensive illustration of the computations involved.

CONCLUSION

For the reasons stated herein and in our opening brief, the decision of the Tax Court should be reversed, and the case should be remanded for further proceedings with respect to the correct amount of the deficiency attributable to the adjustment of the taxpayer's gross income for the fiscal year ended June 30, 1968, under Section 481 of the Code.

Respectfully submitted,

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MAY, 1977.

CERTIFICATE OF SERVICE

It is hereby certified that service of this reply brief has been made on opposing counsel by mailing four copies thereof on this 25th day of May, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

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Address Reply to the
Division Indicated
and Refer to Initials and Number

May 25, 1977

MCB:GEA:MJRoach:lct
5-13593

A. Daniel Fusaro, Esquire
Clerk, U.S. Court of Appeals
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New York, New York 10007

Re: Schuster's Express, Inc. v. Commissioner
(C.A. 2 - No. 76-4277)

Dear Mr. Fusaro:

We are transmitting herewith for filing with your Court ten copies of the reply brief on behalf of the Appellant in the above-entitled case.

We are forwarding four additional copies to counsel for the Appellee, together with a copy of this letter.

Sincerely yours,

MYRON C. BAUM
Acting Assistant Attorney General
Tax Division

By: Gilbert E. Andrews/mk
GILBERT E. ANDREWS
Chief, Appellate Section

Enclosures

cc: Newton D. Brenner, Esquire
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